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C O N F I D E N T I A L SECTION 01 OF 03 COLOMBO 000495

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STATE PASS USTR

E.O. 12958: DECL: 03/25/2013
TAGS: ECON PTER EINV CE LTTE ECONOMICS
SUBJECT: SRI LANKA: ECONOMIC GULF BETWEEN NORTH AND SOUTH POISED TO WIDEN

REF: A. COLOMBO 172 (NOTAL)

¶B. 02 COLOMBO 893 (NOTAL)

Classified By: Deputy Chief of Mission W. Lewis Amselem. Reasons: 1.5 (b, d)

¶1. (C) Summary: The economic gulf between northern and southern Sri Lanka, formed over two decades of conflict, is poised to widen in the coming years. Sri Lanka, though nominally a united nation, is in fact divided on multiple fronts - political, military, social and economic. Since the formal cease-fire came into effect just over one year ago, the economic differences between north and south have persisted. In the south, the economy has benefited from the cease-fire, and the government of Sri Lanka (GSL) has initiated ambitious economic reform plans that aim to improve the nation's productivity and per capita income. In the north, meanwhile, the Liberation Tigers of Tamil Eelam (LTTE) has kept the areas it controls isolated, endangering prospects for a peace dividend. Continued divergence of these two economies will increase the substantial north/south wealth gap and lengthen the odds for peace in a united Sri Lanka. End Summary.

One country, two systems

¶2. (U) When the formal cease-fire began in February 2002, Sri Lanka's economic landscape was characterized by two distinct economic systems - one run by the LTTE in the north, and one run by GSL in the rest of the country. The two systems were underpinned by radically different economic philosophies and world-views. As would be expected, the two systems produced radically different results.

¶3. (U) During two decades of civil war, GSL succeeded in strengthening its trading links with the global economy by developing a range of export-oriented industries. Thriving tea and apparel exports centered in the south helped propel the overall Sri Lankan economy to an average annual growth rate of 5% in the 1990s. Repeated LTTE terrorist attacks, including in the heart of Colombo, did not halt the south's steady rise in average living standards. In the north, by contrast, frequent and heavy fighting ravaged the local economy: LTTE held areas saw very little formal economic activity over a period of twenty years. In 1995, GSL imposed an economic embargo on the LTTE that further isolated and weakened the region's economy. The end result was a dramatic difference in wealth between north and south. A local think tank estimated in 2001 that GDP per capita in the Western Province (which includes greater Colombo as well as poorer outlying areas) stood at $1400, while per capita income in the North and North Eastern Provinces stood below $400.

¶4. (U) One of GSL's early objectives after the cease-fire began was to re-integrate the economies of north and south. It lifted the economic embargo on LTTE areas and re-opened the A9 road linking Jaffna with the south. GSL encouraged traders to do business island-wide, in the hopes of stimulating domestic commerce. One year later, however, we find that economic integration of north and south has not materialized and the two economic systems are set to move further apart.

The South: GSL prioritizes growth

¶5. (U) The February 2002 cease-fire had immediate and positive benefits for the economy of the south. In 2002 overall economic growth will come in at around 3%, a big improvement over the 1.3% contraction the economy experienced in 2001. (Note: Overall Sri Lanka growth rates are a reasonable proxy for growth in GSL-held areas. The Central Bank includes estimates of economic activity in LTTE held areas in its overall GDP figures, but the numbers from the north are not large enough to sway significantly the magnitude of growth measured in the rest of the island. End Note.) Much of the improved economic performance was due to better crop yields, particularly in tea and paddy production. But a cease-fire conducive to tourism and foreign investment

also played a role. Tourist arrivals in 2002 increased by 8%, and foreign direct investment was up 35% to $230 million.

¶6. (U) GSL is wisely not content with 3% growth. It has launched an ambitious plan - summarized in a policy document called "The Future: Regaining Sri Lanka" - for achieving long term growth rates of 8-10%. The document begins by acknowledging that some sectors of Sri Lanka's economy have remained inefficient and uncompetitive, subsidized by more productive sectors. It then lays out a strategy for achieving growth targets by "removing the barriers to productivity and putting in place review mechanisms to ensure that new barriers do not arise."

¶7. (U) Thus far, after 16 months in office, the United National Front government of Prime Minister Ranil Wickremesinghe has made solid progress toward productivity improvements. A new wave of privatization of state-run enterprises has begun, with GSL having sold off full or partial stakes in oil, telecom, mass transit and insurance. To improve the efficiency of labor markets, GSL has enacted legislation that gives employers more flexibility to entrench staff when necessary. GSL has also begun to contain the budget deficit by limiting government spending and putting in place measures to improve revenue collection. While implementation of "Regaining Sri Lanka" is only in the early stages, GSL's performance to date indicates it has a credible chance of achieving the dramatic growth rates it desires.

The North: LTTE prioritizes control

¶8. (C) The sophisticated policy prescriptions of "Regaining Sri Lanka" are a world away from the on-the-ground situation in Sri Lanka's war-torn north. The LTTE's plan for economic growth - to the extent there is one - appears to be focused on aid, not trade. The LTTE rightly reasons that it is easier to control aid flows than it is to control capital flows. It will gladly accept donor funds targeted at reconstructing the north, because it can control how and where the money is spent. Opening up the north to commerce, by contrast, would require the LTTE to sacrifice some degree of control over the lives of the local people - one sacrifice the LTTE is not willing to make.

¶9. (C) In a press conference last April, LTTE leader Velupillai Prabhakaran voiced the LTTE's commitment to pursuing an open economy. But the actions of the group indicate just the opposite: it is building a centrally-planned economy based on a quasi-socialist model. The LTTE is developing a sophisticated financial system (ref A), but that system rests entirely in its hands, without any apparent role for the private sector. The LTTE does permit trade, but its prohibitive taxation system - especially its "import duties" into the areas it controls - serve to dampen economic activity. The LTTE has done nothing to attract investment from Colombo's blue chip corporates, much less from foreign firms. The Tigers have made a few patriotic appeals to the Tamil diaspora to invest in the "Tamil homeland," but it has shown no interest in working with GSL's Board of Investment to lure capital to the north.

¶10. (C) To be fair, the LTTE does not have many economic resources to work with in the north. Even before the ethnic conflict broke out, infrastructure in the north was much less developed than in the south. And mother nature has not been as kind to the north as to the south: the land is less fertile and incapable of producing high value crops like the tea grown in south-central Sri Lanka. The Wanni region where the LTTE is based, for instance, is exactly the kind of harsh jungle terrain you would expect to be home to an insurgency movement. Still, the economic policies of the LTTE since the cease-fire have made a bad economic situation worse. If the LTTE continues to prioritize maintaining its own control higher than fostering trade, it will share the poor performance of the world's other centrally-planned economies. Aid flows may provide a temporary boost to the region, but long-term growth in living standards will not materialize. And the gap between north and south will widen instead of shrinking.

Comment: Implications for peace

¶11. (C) The economic divisions that formed between north and south over two decades of war have crystallized during the past year. Both the LTTE and GSL have settled into their preferred economic models: in the south, a free market economy based on trade; in the north, a centrally planned economy based on future aid. Unfortunately, these divergent systems cast doubt on the future of the peace process. If current trends continue, the south will continue to outgrow the north, widening the prosperity gap between the regions. The underlying economic tensions, therefore, that helped

spawn the war will not disappear, nor will the risk of further conflict.

¶12. (C) Furthermore, the LTTE's unwillingness to open the economy of the north to trade belies its commitment to a federal system. If the LTTE were truly committed to remaining part of a united Sri Lanka, it would welcome rather than eschew trade links with the south and the rest of the world. Instead, the LTTE's economic strategy is more indicative of an organization intent on walling itself off in a de facto separate state.

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